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# Power to the People: How the SEC Can Empower the Crowd

R. Kevin Saunders, II

# Power to the People: How the SEC Can Empower the Crowd


ABSTRACT

*Crowdfunding emerged as a heralded capital-formation mechanism at a time when capital markets desperately need it, but is it actually viable? Following passage of the JOBS Act and issuance of proposed rules by the SEC, equity crowdfunding will soon become reality. When signing the JOBS Act, President Obama touted it as a means "to increase American job creation and economic growth," but that will only hold true for Title III, Crowdfunding, if the SEC creates an attractive market for high-quality projects. The SEC's proposed rules impose a heavy disclosure burden relative to a low maximum offering amount, offering a poor value proposition to aspiring entrepreneurs. Consequently, the proposed crowdfunding market is more likely to attract low quality projects that cannot find funding elsewhere.*

*This Note contends that reducing disclosure requirements, allowing portals greater discretion to screen projects, and facilitating active crowd participation in selecting high-quality investments would be more consistent with the aims of both the JOBS Act, in particular, and securities regulation, in general. This Note recommends the Commission initially adopt a light regulatory approach, let the market regulate itself where practicable, and impose harsher regulation only where necessary.*


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In 1886, the renowned journalist and press baron Joseph Pulitzer ran an advertisement in his newspaper soliciting donations to help build a pedestal for the newly constructed Statue of Liberty.[1] Pulitzer promised donors a six-inch replica statuette in exchange for $1 or a twelve-inch version for $5.[2] Over six months, individuals donated nearly $100,000,[3] with the majority of donations under $1.[4] Some 120 years later, a revolutionary high-volume, low-amount, donation-based capital market emerged—crowdfunding.[5]

Crowdfunding is an online marketplace (portal) that connects aspiring entrepreneurs, who possess a great idea but no money, with a large audience of Internet users (the crowd), whom these companies hope will each contribute a small amount.[6] Crowdfunding has the potential to infuse previously inaccessible capital into our sputtering economy because it connects companies that otherwise could not arrange funding with individuals who otherwise would not invest.[7] Title III of the Jumpstart Our Business Startups (JOBS) Act carved out an exemption from securities registration for crowdfunded

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1. *See The JOBS Act: Economic Boon or Peril?*, MASSOLUTION (Aug. 14, 2013), http://events.massolution.com/the-jobs-act-economic-boon-or-peril.

2. *Id.*

3. The equivalent of $2.4 million today. *Id.*

4. *Id.*; *see also* Julie Blair Pitts, *Pulitzer Crowdfunded the Statue of Liberty?*, DAILY CROWDSOURCE, http://dailycrowdsource.com/content/crowdfunding/169-pulitzer-crowdfunded-the-statue-of-liberty (last visited Dec. 28, 2013) ("The most incredible aspect of his campaign is that the over 120,000 donations were in most cases less than a dollar.").

5. *See The JOBS Act: Economic Boon or Peril?*, *supra* note 1.

6. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011).

7. *Id.* at 931–32. This Note will focus solely on the crowdfunding market in the United States, though advanced crowdfunding markets exist in many countries (e.g., the United Kingdom, Ireland, Australia, and Germany). *See* Gerrit K.C. Ahlers et al., *Equity Crowdfunding*, 10–11 (Dec. 2, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2362340.

offerings, thereby creating an equity-based crowdfunding market.[8] This revolutionary market would, if viable, reduce businesses' dependence on large institutions to arrange financing, while simultaneously offering promising investments to the public that were previously available only to the wealthy.[9]

Despite crowdfunding's promise, the Securities & Exchange Commission's (SEC or Commission) proposed regulations seek to create a market that offers perhaps the worst value proposition of any capital formation mechanism available to small businesses.[10] The final regulations can further the primary goals of securities regulation by increasing access to capital for small businesses while protecting the interests of investors.[11] Crowdfunding's radical nature poses yet unanswered questions, which will require innovative regulation.[12] Using its broad statutory authorization, the Commission should adopt a trial-and-error approach to striking the appropriate balance, using a light regulatory touch initially and imposing harsher regulation only where necessary.[13] I propose that the final regulations should reduce the amount of disclosure to a level commensurate with the nature of crowdfunded companies, empower portals to police offerings, and facilitate full communication between members of the crowd.[14]

This Note analyzes how the SEC's crowdfunding rules could satisfy the aims of securities regulation.[15] Part I explores the economic environment that gave rise to the JOBS Act, provides a brief overview of crowdfunding's role within the overall securities market, and discusses the salient features of the SEC's proposed regulations,

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8. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 301 et seq., 126 Stat. 306, 315–23 (2012).

9. Andrew A. Schwartz, *Keep it Light, Chairman White: SEC Rulemaking under the CROWDFUND Act*, 66 VAND. L. REV. (EN BANC) 43, 44–45 (2013).

10. *See* Crowdfunding, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249); Zachary J. Gubler, *Inventive Funding Deserves Creative Regulation*, WALL ST. J. (Jan. 31, 2013, 6:50 PM), http://online.wsj.com/news/articles/SB10001424127887323468604578251913868617572; *The JOBS Act: Economic Boon or Peril?*, *supra* note 1.

11. *See* Crowdfunding, 78 Fed. Reg. at 66,431 ("Upon adoption of final rules, the Commission staff will monitor the market for offerings made in reliance on Section 4(a)(6), focusing in particular on the types of issuers using the exemption, . . . and whether the exemption is promoting new capital formation while at the same time providing key protections for investors.").

12. *See* Steven M. Davidoff, *Trepidation and Restrictions Leave Crowdfunding Rules Weak*, N.Y. TIMES DEALBOOK, (Oct. 29, 2013, 5:10 PM), http://dealbook.nytimes.com/2013/10/29/trepidation-and-restrictions-leave-crowdfunding-rules-weak.

13. *See id.*; *see also* Schwartz, *supra* note 9, at 55 (proposing that the SEC should wait to see how crowdfunding works in practice before tacking on additional rules).

14. *See infra* Part III.

15. *See* Crowdfunding, 78 Fed. Reg. at 66,428.

noting where they deviate from the JOBS Act.[16] Part II analyzes these proposed regulations to assess whether the disclosure requirements, the crowdfunding community (the crowd), and the unique function of portals are sufficient fraud safeguards, thereby allowing crowdfunding to fulfill its potential as a viable securities market.[17] Part III outlines the original purpose of the crowdfunding exemption and suggests an alternative crowdfunding framework more consistent with these goals.[18] This Note ultimately recommends a statutory framework that reduces issuers' disclosure burden, yet still provides investors with adequate protection via portals' screening efforts and the active participation of the crowdfunding community in selecting quality investments.[19]

## I. SETTING THE STAGE

Crowdfunding's success in a nonequity setting flourished largely in the absence of regulation, but the paucity of capital available to entrepreneurs necessitated an equity-based market.[20] The factors that motivated this radical market and the evolution of the resultant legislation are discussed below.

### *A. For the People, By the People*

Crowdfunding is broadly defined as "efforts by entrepreneurial individuals and groups—cultural, social, and for-profit—to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet [sic], without standard financial intermediaries."[21] In its original format, known as donation- or rewards-based crowdfunding, individuals donate a set amount of money in exchange for a prespecified reward, such as a copy of the finished product (i.e., a CD, movie, widget, etc.) or a chance to

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16. *See infra* Part I.
17. *See infra* Part II.
18. *See infra* Part III.
19. *See infra* Part II.C.
20. *See* C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 197 (2012).
21. Ethan R. Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 2 (2014), *available at* http://ssrn.com/abstract=2088298. Crowdfunding borrows heavily from the concept of crowdsourcing, which involves companies drawing small labor contributions from a large number of individuals on the Internet to alter their production structure. *See generally* Erin R. Frankrone, Note, *Free Agents: Should Crowdsourcing Lead to Agency Liability for Firms?*, 15 VAND. J. ENT. & TECH. L. 883 (2013) (noting the prevalence of crowdsourcing as a viable means for accumulating resources).

attend a live-recording session.[22] Kickstarter, the preeminent crowdfunding portal, demonstrates the power of this business model, having successfully raised over $1.06 billion for almost 60,000 projects since its inception in 2009.[23]

Over the past few years, crowdfunding has generated significant organic momentum through the rise of websites like Kickstarter and Indiegogo.[24] The crowdfunding market doubled in size in the last year alone and has become an attractive financing option for a myriad of small businesses and start-ups seeking capital.[25] Start-ups ranging from a Bluetooth-enabled wristwatch manufacturer[26] to a New York crab shack[27] have found great success funding their ventures mimicking Pulitzer's model.[28] Music and film productions, in particular, are well suited for donation-based crowdfunding because investors will accept nonmonetary returns on their donation, such as satisfaction from contributing to an entrepreneurial initiative, early access to the product, or an opportunity to meet the creator.[29]

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22. Ajay K. Agrawal et al., *Some Simple Economics of Crowdfunding* 12 (Nat'l Bureau of Econ. Research, Working Paper No. 19133, 2013), *available at* http://www.nber.org/papers/w19133.

23. *Kickstarter Stats*, KICKSTARTER, http://www.kickstarter.com/help/stats (last visited Apr. 10, 2014).

24. *See* KICKSTARTER, www.kickstarter.com (last visited Feb. 12, 2014); INDIEGOGO, www.indiegogo.com (last visited Feb. 12, 2014).

25. Crowdfunding volumes in North America grew 108 percent to $1.6 billion in 2012. *Crowdfunding Market Grows 81% in 2012: Crowdfunding Platforms Raise $2.7 Billion and Fund More Than One Million Campaigns, Finds Research Firm Massolution*, PR NEWSWIRE, Apr. 8, 2013, *available at* http://www.prnewswire.com/news-releases/crowdfunding-market-grows-81-in-2012-crowdfunding-platforms-raise-27-billion-and-fund-more-than-one-million-campaigns-finds-research-firm-massolution-201911701.html.

26. Mark Nowotarski, *Getting Your Invention off of the Ground with Crowdfunding*, IPWATCHDOG (June 29, 2013, 9:05 AM), http://www.ipwatchdog.com/2013/06/29/getting-your-invention-off-of-the-ground-with-crowdfunding (documenting the story of the Pebble smartwatch, the most successful Kickstarter project to date, which raised over $10 million).

27. *Littleneck - A Clam Shack Coming Soon to Gowanus!*, KICKSTARTER, https://www.kickstarter.com/projects/littleneck/littleneck-a-clam-shack-coming-soon-to-gowanus (last visited Mar. 28, 2014).

28. *See The JOBS Act: Economic Boon or Peril?*, *supra* note 1.

29. *See, e.g.*, Agrawal et al., *supra* note 22; Thaya Brook Knight et al., *A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 135, 136 (2012) (discussing the disproportionate success of projects exhibiting a sufficient 'cool factor'); *Crowdfunding Market Grows*, *supra* note 25 (documenting how Performing Arts (11.9 percent) and Music & Recording Arts (7.5 percent) projects account for a large percentage of total crowdfunded ventures); Perry Chen, Yancey Strickler, & Charles Adler, *The Truth About Spike Lee and Kickstarter*, KICKSTARTER BLOG (Aug. 19, 2013), http://www.kickstarter.com/blog/the-truth-about-spike-lee-and-kickstarter-0 (citing the success of Veronica Mars, Zach Braff, and Spike Lee as crowdfunding creators).

As crowdfunding gains prominence, entrepreneurs grow increasingly creative in utilizing this investment model.[30] For example, one start-up recently attempted to raise $300 million to purchase the Pabst Brewing Company by promising an amount of beer proportionate to the investment and a "crowdsourced certificate of ownership."[31] Similarly, the human-rights organization AHUMANRIGHT is currently accepting donations to launch a communications satellite into orbit that would provide Internet access to third-world countries.[32] Other portals arrange peer-to-peer lending markets, matching borrowers and lenders with similar risk profiles.[33]

Despite this burgeoning market, small businesses' demand for capital far outweighs supply in the United States.[34] The demand for new investment is estimated to be around $13 *trillion* over the course of the next decade.[35] In 2011, approximately 600,000 small businesses reported being entirely shut-off from credit, with an additional 800,000 obtaining less than they desired.[36] Yet, 58 percent of all American adults maintain that they are willing to help fund a start-up

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30. Even President Obama utilized crowdfunding to raise over $100 million in small contributions during the 2008 presidential election. *See* Ahlers et al., *supra* note 7, at 10–11. Mature companies are similarly pursuing this capital, as evidenced by DodgeDartRegistry.com, where an entrepreneurial youth can virtually assemble a replica of his/her dream Dodge Dart and then solicit donations from friends and family to pay for parts or features of the car. DODGE DART REGISTRY, www.dodgedartregistry.com (last visited Feb. 12, 2014).

31. *See* Matthew Hutchens, *Hitting the Target: How New Disclosure Rules Could Improve the Jumpstart Our Business Startups Act* 3–4 (Sept. 27, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2332248. Alas, after a promising start saw the venture raise over $200 million from five million discrete investors, the SEC shut down the campaign for failure to register as an offering of securities. *Id.* At the time, no securities exemption permitted crowdfunded ventures to offer an ownership stake without registering with the SEC, which the certificate of ownership violated. *See id.* at 4; Bill Singer, *SEC Skunks Pabst BuyaBeerCompany Deal*, FORBES BLOG (June 8, 2011, 3:21 PM), http://www.forbes.com/sites/billsinger/2011/06/08/sec-skunks-pabst-buyabeercompany-deal.

32. *See* BUY THIS SATELLITE, http://www.buythissatellite.com (last visited Oct. 30, 2013).

33. These loans can assume an altruistic structure (i.e., requiring the borrower to repay only the principal amount without interest) or an investment structure (i.e., requiring repayment of principal plus interest). *Compare* KIVA, www.kiva.com (arranging altruistic, nonprofit loans starting as low as $25 with the goal of alleviating poverty) (last visited Apr. 10, 2014), *with* PROSPER, www.prosper.com (offering loans with annual percentage rates ranging from 6.25–35.36 percent) (last visited Feb. 12, 2014).

34. *See* Paul White, *Comments on SEC Regulatory Initiatives under the JOBS Act: Title III – Crowdfunding*, SEC.GOV (July 22, 2013), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-248.pdf.

35. *See id.*

36. NAT'L FED'N OF INDEP. BUS., RESEARCH FOUNDATION, SMALL BUSINESS, CREDIT ACCESS, AND A LINGERING RECESSION 30 (Jan. 2012), *available at* http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/small-business-credit-study-nfib-2012.pdf.

or expanding small business in pursuit of the American Dream.[37] Crowdfunding has the potential to remedy this market inefficiency because it connects entrepreneurs who could not otherwise arrange financing with public investors who would not otherwise invest in startups.[38] One estimate projects a $300 billion infusion of capital into the economy if Americans move just 1 percent of their investable assets into crowdfunding.[39] But funders require financial returns on their investment to invest in large enough quantities to satiate the demand for capital, which would bring the transactions under the purview of securities regulation.[40]

### *B. Crowdfunding Investments as Securities*

Prior to the JOBS Act, crowdfunding operated in the absence of government regulation. Though the crowdfunding market was not regulated, it was initially unclear if some of these companies were actually offering securities, which would require compliance with extensive registration requirements before selling these financial interests.[41] Then, the Commission issued cease-and-desist orders to a number of issuers, thereby establishing limits on nonequity crowdfunding.[42] This left entrepreneurs searching for a method to access the vast amount of untapped capital while avoiding the

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37. *See* White, *supra* note 34 (noting that the average crowdfunding investment is $1300 and 69 percent of investors earning greater than $75,000 per year would be willing to invest an average of $1,900 per year).

38. *See* Bradford, *supra* note 20, at 196.

39. *Raising Capital Online: The New Thundering Herd*, ECONOMIST, June 16, 2012, http://www.economist.com/node/21556973 (quoting venture capitalist Fred Wilson).

40. *See* Bradford, *supra* note 20, at 197.

41. *See* 15 U.S.C. § 77b(a)(1) (2012) (defining the term "security" for the purposes of the Securities Act of 1933 to include investment contract). An investment contract is

> [A] contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

S.E.C. v. W. J. Howey Co., 328 U.S. 293, 298–99 (1946) (interpreting the meaning of "investment contract" in the Securities Act).

42. *See* Zachary Griffin, *Crowdfunding: Fleecing the American Masses*, CASE W. RES. J.L., TECH. & INTERNET (unpublished note), *available at* http://ssrn.com/abstract=2030001 (detailing the trials and tribulations of ProFounder.com); *see also* Mikal E. Belicove, *Ohio Investigating Crowdfunding Platform SoMoLend*, FORBES BLOG (Aug. 13, 2013, 7:55 PM), http://www.forbes.com/sites/mikalbelicove/2013/08/13/ohio-investigating-crowdfunding-platform-somolend (describing how Ohio security regulators shut down SoMoLend, a portal connecting borrowers with lenders, for securities fraud); Singer, *supra* note 31 (recounting the valiant attempt to crowdfund the purchase of the Pabst Brewing Company).

extensive disclosure requirements for reporting companies, which would render the cost of an offering prohibitive.[43]

But equity-based crowdfunding clearly fits within the classic definition of an investment contract.[44] Consequently, these offerings are subject to the registration requirements of the Securities Act of 1933 (Securities Act) absent an applicable exemption.[45] No existing exemption applied to crowdfunded companies until the JOBS Act created one.[46]

### *C. The JOBS Act and Proposed SEC Regulations*

In response to the pent-up demand for start-up capital in a post-recession economy and the lack of a market mechanism to facilitate it, Congress introduced the JOBS Act, which President Obama signed into law on April 5, 2012.[47] The JOBS Act is intended "to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[48] The legislation is an agglomeration of bills that collectively seek to improve small businesses' access to capital.[49] Specifically, Title III adds Section 4(a)(6) to the Securities Act, creating an exemption from the registration requirements of Securities Act Section 5 for equity-based crowdfunded offerings.[50] The legislation, when it takes effect,[51] will permit issuers to offer a financial interest in their business, either debt or equity, in exchange for a set investment of money.[52]

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43. *See* Bradford, *supra* note 20, at 196–97.

44. *See* Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1740 (2012) (noting that the statutory term "investment contract" is broadly construed to encompass any fundraising effort that expressly or impliedly offers investors a potential return on their investment, including notes and indebtedness).

45. *See* Bradford, *supra* note 20, at 196.

46. *Id.* at 196–97.

47. *See* Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 101 et seq., 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.); Press Release, Office of the Press Secretary, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2010), *available at* http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing.

48. JOBS Act § 101, 126 Stat. at 306.

49. Title I of the JOBS Act broadens the scope of an 'emerging growth company,' *see id.* §§ 101–08, while Title II relaxes the ban on general solicitation of accredited investors, *see id.* § 201.

50. Crowdfunding, 78 Fed. Reg. 66,428, 66,429–30 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240 and 249).

51. After accepting comments on the proposed regulations the SEC must promulgate final regulations and provide FINRA sufficient time to structure a market framework. *See* David Drake, *Why Equity Crowdfunding Won't Happen This Year*, FORBES (Feb. 19, 2013, 10:22 AM), http://www.forbes.com/sites/groupthink/2013/02/19/why-equity-crowdfunding-wont-happen-this-year.

52. *See* Bradford, *supra* note 20, at 197.

While the JOBS Act outlines crowdfunding's general regulatory framework, the SEC must promulgate final regulations.[53] Consequently, the Commission assumed the daunting task of implementing rules for the crowdfunding market that strike the proper balance between the two primary tenets of securities regulation: (1) improving access to capital and (2) protecting the interests of investors.[54] On November 5, 2013, the SEC issued its proposed rules, starting the clock on a ninety-day comment period, after which it will promulgate final regulations.[55]

1. Concerning Issuers

Consistent with the text of the JOBS Act, the Commission proposes to cap the maximum amount of crowdfunded securities any issuer may offer at $1 million in any twelve-month period.[56] Further, it establishes three tiers of offerings, each carrying varying levels of disclosure, identical to those proposed by the JOBS Act.[57] Prior to offering crowdfunded securities, an issuer with a target objective of $100,000 or less must submit tax returns from the previous fiscal year (if any) and unaudited financial statements.[58] For target offerings greater than $100,000 but less than $500,000, an issuer is required to submit financial statements certified by an independent public accountant.[59] For any offering above $500,000 to the $1 million ceiling, issuers must submit audited financial statements.[60] In addition, all issuers must provide a narrative discussion of their financial condition, similar to a Management Discussion & Analysis (MD&A) for reporting companies, which addresses the historical results of the issuer's operations and, to the extent material, its liquidity and capital resources.[61] For issuers without a prior operating

53. The Blunderbuss Clause requires issuers to comply with "such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest." JOBS Act § 302, 126 Stat. at 317.

54. *See supra* note 11 and accompanying text.

55. Crowdfunding, 78 Fed. Reg. at 66,428.

56. The SEC took great care to explain that capital raised via other means (e.g., Regulation D exemption) should not be counted in determining aggregate amount sold in any given twelve-month period. *See id.* at 66,431.

57. *See* JOBS Act § 302, 15 U.S.C. § 77d-1(b) (2012).

58. *Id.* § 77d-1(b)(1)(D)(i).

59. *Id.* § 77d-1(b)(1)(D)(ii).

60. *Id.* § 77d-1(b)(1)(D)(iii).

61. For issuers with prior operating history, discussion should focus on "whether historical earnings and cash flows are representative of what investors should expect in the future." Crowdfunding, 78 Fed. Reg. at 66,444. Further the Commission recognizes that companies utilizing the Crowdfunding exemption are unlikely to be as large and complex as traditional reporting companies, thus the discussion of their financial condition will generally not be as detailed and lengthy as a MD&A. *See id.*

history, the narrative can be prospective, focusing on financial milestones and the various risks associated with the venture.[62]

The proposed rules would not prohibit issuers from accepting investments in excess of the target-offering amount, capped at the $1 million maximum, provided they have exceeded the target before a prespecified deadline.[63] If an offeror elects to accept investments in excess of the target-offering amount, however, then it must disclose how much it is willing to accept, how the excess funds will be allocated, and the intended purpose for the additional funds.[64] To determine the requisite degree of financial disclosure, an issuer must aggregate all crowdfunding proceeds raised in the preceding twelve-month period with the target-offering amount, including the maximum oversubscription it is willing to accept.[65]

In addition to these basic financial disclosures, issuers are subject to more extensive disclosure requirements intended to provide investors with sufficient information to form an educated opinion regarding the quality of investment.[66] These include, *inter alia*: the public price of the securities or a method for determining the price, a description of the issuer's ownership and capital structure, a description of the material terms of any indebtedness of the issuer, a description of exempt offerings conducted within the past three years, and material transactions.[67] Finally, issuers are required to provide regular updates on their progress towards the target-offering amount.[68] The JOBS Act listed the requisite general information that issuers must submit prior to issuance of securities, though it did not mandate the format for conveying this information to investors.[69] The proposed rules specify that the mandated disclosures must be

62. If an issuer does not have a prior operating history, discussion should focus on "financial milestones and operational, liquidity and other challenges." *Id.*

63. *See id.* at 66,457–58.

64. *Id.* at 66,440.

65. For example, if an issuer sets their target at $450,000 but elects to accept investment up to a maximum of $750,000, then they must submit audited financial statements. *See id.* at 66,445.

66. *Id.* at 66,522.

67. The following information is also among the required disclosures: name, legal status, physical and website address of the business; pertinent information regarding directors and officers, as well as beneficial owners (i.e. persons owning 20 percent or more outstanding voting equity); a description of the business and anticipated business plan; stated purpose and intended use of the proceeds; a discussion of the material factors that make the investment speculative or risky; a description of the process to complete the transaction or cancel an investment commitment; the amount of compensation paid to the intermediary. *Id.* at 66,438.

68. *Id.*

69. "We recognize that there are numerous ways to achieve that goal and, as such, we are not proposing to mandate a specific disclosure format." *Id.*

submitted on the SEC's Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) database using Form C.[70]

But the disclosure requirements for issuers do not end there.[71] Under the proposed rules, an issuer would be subject to ongoing reporting requirements similar to the information required in the offering statement, including information about its financial condition.[72] Companies must file these reports annually until one of three events occurs:

> (1) The issuer becomes a reporting company required to file reports under the Exchange Act of 1934; (2) the issuer or another party purchases or repurchases all of the securities . . . including any payment in full of debt securities or any complete redemption of redeemable securities; or (3) the issuer liquidates or dissolves its business in accordance with state law.[73]

Any issuer who does not comply with these ongoing reporting requirements is excluded from offering crowdfunded securities until it files the two most recent annual reports.[74]

The proposed rules prohibit the following categories of issuers from using Section 4(a)(6) to issue securities:[75] (1) non-US issuers; (2) reporting companies; (3) investment companies; (4) issuers that are disqualified pursuant to the disqualification provisions of Section 302(d) of the JOBS Act; (5) issuers who have not complied with annual ongoing reporting requirements; and (6) issuers lacking a specific business plan or whose business plan is to engage in a merger or acquisition with unidentified company.[76]

The JOBS Act text held issuers liable for material misstatements and omissions, without including a scienter element.[77] The proposed regulations then added a 'substantial compliance' provision, similar to Rule 508 of Regulation D, to protect unsophisticated investors from liability for merely negligent omissions.[78] This provision shields issuers from liability if a material omission or misrepresentation is "not misleading, provided that the

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70. Form C is flexible, requiring the submission of certain disclosures in a specified format, while allowing issuers to format the remaining disclosures according to their preferences. *Id.* at 66,449. EDGAR is the online filings database of the SEC and is available at http://www.sec.gov/edgar.shtml.

71. *See* Crowdfunding, 78 Fed. Reg. at 66,450–52 (discussing the ongoing reporting requirements).

72. *Id.* at 66,451.

73. *Id.* These reports must be filed on EDGAR no later than one hundred and twenty days after the close of the most recent fiscal year covered by the report. *Id.*

74. *Id.* at 66,437 (discussing the exclusion of certain issuers from eligibility under Section 4(a)(6)).

75. *Id.* at 66,436.

76. *Id.*

77. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 4A(c), 126 Stat. 306 (2012).

78. *See* Bradford, *supra* note 20, at 219 (citing Securities Act of 1933, § 4A(c)(2)(A)–(B)).

purchaser did not know of the untruth or omission, and the issuer does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of the untruth or omission."[79]

### 2. Concerning Investors

The proposed rules contain the same bifurcated investor classes the JOBS ACT suggested,[80] but clarify potential ambiguity regarding the annual investment limitation.[81] Any investor whose annual income and net worth are each less than $100,000 is limited to an aggregate crowdfunding investment of $2,000 or 5 percent of annual income or net worth, whichever is greater, in any given twelve-month period.[82] If *either* annual income *or* net worth exceeds $100,000, then the aggregate investment is limited to 10 percent of the greater of annual income or net worth, not to exceed $100,000 in any given twelve-month period.[83] Issuers are permitted to rely on an intermediary's representation that an investment will not cause an investor to exceed their limitation for the preceding twelve-month period.[84]

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79. Crowdfunding, 78 Fed. Reg. at 66,499; *see also id.* at 66,499 n.745 ("The anti-fraud and civil liability provisions of the Securities Act, such as Sections 12(a)(2) and 17, apply to exempted transactions."). Under this liability provision, an investor who purchases securities in a crowdfunding transaction may bring an action against the issuer to recover the consideration paid for the security, with interest, or damages if the person no longer holds the security. *See id.* at 66,499.

80. *Compare* JOBS Act § 302(a)(6)(B), *with* Crowdfunding, 78 Fed. Reg. at 66,431–32.

81. *See* Crowdfunding, 78 Fed. Reg. at 66,433. The proposed rules observe:

> Several commenters noted that Sections 4(a)(6)(B)(i) and (ii) technically subject some investors to two potential investment limits. The language of the statute may be read to create potential conflicts or ambiguity between the two investment limits because paragraph (i) applies if "either" annual income or net worth is less than $100,000 and paragraph (ii) applies if "either" annual income or net worth is equal to or more than $100,000. . . .
>
> We believe that the appropriate approach is to the investment limit provision is to provide for an overall investment limit of $100,000, but within that overall limit, to provide for a "greater of" limitation based on annual income and net worth.

*Id.*

82. Annual income and net worth are calculated in accordance with the Commission's rules for determining accredited investor status. *See* 17 C.F.R. § 230.501(a) (2013). Consistent with these rules, the calculation of a natural person's net worth for purposes of the investment limit would exclude the value of the primary residence of such person. *See* 17 C.F.R. § 230.501(a)(5)(i)(B). A natural person's income for purposes of the investment limit calculation would be the lower of such person's income for each of the two most recent years as long as such person has a reasonable expectation of the same income level in the current year. *See* 17 C.F.R. § 230.501(a)(6).

83. Crowdfunding, 78 Fed. Reg. at 66,430.

84. The standard of liability is "reasonable belief" meaning that if the issuer has knowledge the investor has, or would, exceed their limit they may not rely on an intermediary's contrary representation. *Id.* at 66,432.

### 3. Concerning Portals

The JOBS Act created a unique class of financial intermediaries, called portals, specifically designed to facilitate crowdfunded transactions.[85] The proposed rules define a portal as "an Internet website or other similar electronic medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6)."[86] The Commission intends to limit an issuer to one portal for any given issuance of crowdfunded securities.[87] Unlike traditional broker-dealer intermediaries, crowdfunding portals cannot offer investment advice or recommendations to investors.[88] Portals are additionally prohibited from offering compensation to "promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor."[89] Further, executives and other key employees of the portal may not have any financial interest in an issuer using its portal to solicit funds.[90] Finally, portals must "register with any applicable self-regulatory organization,"[91] as well as be a member of a national securities association that is registered with the Commission.[92]

## II. ALL BARK, NO BITE

Since President Obama signed the JOBS Act into law in April 2012 it has been the subject of intense scrutiny.[93] Proponents hail it

85. Portals, as well as existing broker/dealers, are the exclusive intermediaries for crowdfunded transactions. *See* JOBS Act § 302, 15 U.S.C. § 77d-1 (referring to §4A of the Securities Act of 1933).

86. Crowdfunding, 78 Fed. Reg. at 66,435 ("The proposed rules would accommodate other electronic media that currently exist or may develop in the future. For instance, applications for mobile communication devices, such as cell phones or smart phones, could be used to display offerings and to permit investors to make investment commitments.").

87. *See id.*

88. *See id.* at 66,458.

89. *Id.* at 66,476 (citing Section 4(a)(6) of the Securities Act).

90. *See* JOBS Act § 302, 15 U.S.C. § 77d-1(a)(11) (2012) (referring to § 4A(a)(11) of Securities Act of 1933) ("[P]rohibit its directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services.").

91. *Id.* § 77d-1(a)(2) (referring to § 4A(a)(2) of Securities Act of 1933).

92. The statute requires registration with a self-regulatory organization as defined by §3(a)(80) of the Securities Exchange Act of 1934. At the time of publication, only FINRA satisfies this requirement. *See* Knight, *supra* note 29, at 147 n.44.

93. *See, e.g.*, Jenna Wortham, *Success of Crowdfunding Puts Pressure on Entrepreneurs*, N.Y. TIMES (Sept. 17, 2012), http://www.nytimes.com/2012/09/18/technology/success-of-crowdfunding-puts-pressure-on-entrepreneurs.html ("'The honeymoon period that we are experiencing around crowdfunding is beginning to come to a close,' said Wil Schroter, co-founder and chief executive of Fundable . . . . 'People realize there is real risk involved in investing in

as a disruptive securities market,[94] with the ability to facilitate access to a vast store of capital that traditional investment instruments cannot reach.[95] The legislators who championed the JOBS Act in Congress realized crowdfunding's disruptive potential: "There is now the ability to use the Internet as a way for small investors to get the same kind of deals that up to this point only select investors have gotten . . . ."[96] Many journalists and other commentators following the crowdfunding phenomenon agreed.[97] Conversely, a number of critics decried the legislation as creating a market for fraud.[98]

Mary Schapiro, then-Chairperson of the SEC, initially adopted a cynical stance on the JOBS Act;[99] that attitude permeates the

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anything early-stage, whether it's an idea, a charity or a product, and they're starting to understand they aren't buying off of Amazon.'").

94. *See* Erick Schonfeld, *33Needs Brings Crowdsourced Funding to Social Startups*, TECHCRUNCH (Jan. 31, 2011), http://techcrunch.com/2011/01/31/33needs ("It's a launching pad that builds fans, breeds a loyal base of people who'll buy your stuff and use your product. There is so much pent up demand to invest in this stuff—not donate, but invest.").

95. *See* Press Release, Office of the Press Secretary, *supra* note 47.

> Right now, [start-ups and small businesses] can only turn to a limited group of investors – including banks and wealthy individuals – to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it's time our laws did as well. Because of [the CROWDFUND Act], start-ups and small business will now have access to a big, new pool of potential investors – namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.

*Id.*

96. 158 CONG. REC. S1689 (daily ed. March 15, 2012) (statement of Sen. Mark Warner); *see also* 158 CONG. REC. S1717 (daily ed. March 15, 2012) (statement of Sen. Mary Landrieu) ("[T]his crowdfunding bill . . . is, in essence, a way for the Internet to be used to raise capital . . . .").

97. *See, e.g.*, Gubler, *supra* note 10 ("Crowdfunding has the potential to revolutionize the financing of small business, transforming millions of users of social media such as Facebook into overnight venture capitalists, and giving life to valuable business ideas that might otherwise go unfunded."); *see also The JOBS Act: Economic Boon or Peril?*, *supra* note 1 (positing that the ultimate goal of the JOBS Act is to improve the start-up economy by lowering the threshold to participation, thus allowing more companies to fail faster).

98. *See, e.g.*, Dave Michaels, *SEC to Issue Crowdfunding Proposal Easing Investor Verification*, BLOOMBERG BUSINESSWEEK (Oct. 18, 2013), http://www.businessweek.com/news/2013-10-17/sec-to-release-crowdfunding-rule-easing-investor-verification ("What we are talking about are companies that in all likelihood are not going to be winners, and they are being invested in by people who clearly don't have the expertise and financial smarts of venture capitalists . . . . So you put those together and you are creating a real opportunity for scams and fraud and significant losses." (quoting Lynn Turner, former Chief Accountant of the SEC)); *The JOBS Act Fails Investors and Entrepreneurs*, NASAA.ORG (Apr. 5, 2012), http://www.nasaa.org/12092/the-jobs-act-fails-investors-and-entrepreneurs ("Congress has just released every huckster, scam artist, and small business owner and salesman onto the internet." (quoting Jack Herstein, North American Securities Administrator's Association President)); *The JOBS Act: Economic Boon or Peril?*, *supra* note 1 ("At best, this bill could make it easier for con artists to defraud seniors out of their entire life savings by convincing them to invest in worthless companies. At worst, this bill has the potential to create the next Enron or Arthur Andersen scandal or an even worse financial crisis." (quoting Sen. Bernie Sanders)).

99. *See, e.g.*, David S. Hilzenrath, *Jobs Act Could Remove Investor Protections, SEC Chair Mary Schapiro Warns*, WASH. POST (Mar. 14, 2012), http://www.washingtonpost.com/

proposed regulations.[100] If the proposed regulations are adopted verbatim, the crowdfunding market would arguably become the least efficient means of capital formation—a far cry from the disruptive model that champions praised.[101] These unimaginative regulations fuel speculation that the Commission is hesitant to innovate in light of recent court decisions that require statistical proof to justify Commission actions.[102] But crowdfunding cannot realize its potential to unlock vast stores of capital unless the Commission structures an efficient market such that issuers receive a fair price for their equity.[103]

It is imperative that the entirety of industry regulations and practices jointly crafted by the Commission and portals do not inhibit the crowdfunding market from operating efficiently.[104] The equity-based crowdfunding market generated $116 million in international transactions in 2012, but the market is projected to grow to over $5 billion following the implementation of the crowdfunding exemption in the US.[105] Because this infusion of capital is crucial to economic vitality, the Commission must strike the proper balance between increasing access to capital while protecting the interests of investors, which will allow crowdfunding to fulfill its potential as a viable capital-formation mechanism.[106]

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business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html ("'Too often, investors are the target of fraudulent schemes disguised as investment opportunities,' Schapiro wrote. '[I]f the balance is tipped to the point where investors are not confident that there are appropriate protections, investors will lose confidence in our markets, and capital formation will ultimately be made more difficult and expensive.'"); Ben Protess, *Regulator Seeks Feedback on JOBS Act*, N.Y. TIMES DEALBOOK (Apr. 11, 2012, 4:16 PM), http://dealbook.nytimes.com/2012/04/11/regulator-seeks-feedback-on-jobs-act ("Mary Schapiro, chairwoman of the S.E.C., warned last month that the law would 'weaken investor protection.'").

100. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,430 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

101. Deborah L. Jacobs, *SEC Proposes Crowdfunding Rules*, FORBES (Oct. 23, 2013, 2:41 PM), http://www.forbes.com/sites/deborahljacobs/2013/10/23/sec-proposes-crowdfunding-rules ("The proposed rules are extremely impractical because of the restrictions and procedural hurdles a crowdfunding issuer, investor and funding portal will have to endure to raise capital. Compared to other forms of crowdfunding and capital raising, equity crowdfunding to the public has the worst 'bang for your buck' in all of corporate finance.").

102. *See* Davidoff, *supra* note 12 (claiming the Commission adopted a "bunker mentality" after a string of adverse court decisions, resulting in a higher bar—statistical proof—to justify SEC actions).

103. *See* Agrawal et al., *supra* note 22, at 20–21.

104. *See id.*

105. *See Crowdfunding Market Grows*, *supra* note 25.

106. *See* Crowdfunding, 78 Fed. Reg. at 66,430 ("The proposed rules are intended to align crowdfunding transactions under Section 4(a)(6) with the central tenets of the original concept of crowdfunding, in which the public—or the crowd—is presented with an opportunity to invest in an idea or business and individuals decide whether or not to invest after sharing information about the idea or business with, and learning from, other members of the crowd.").

### *A. A Novel Market Demands a Novel Mechanism*

Balancing these two competing interests—access to capital versus protecting the interests of investors—is especially difficult within the crowdfunding context where there is a dearth of reliable data due to the market's infancy.[107] The typical crowdfunding transaction involves financially unsophisticated individuals investing in inherently risky start-ups, which are more likely to fail than the average publicly owned company, and even less likely to become profitable.[108] Additionally, crowdfunding differs from traditional sources of equity in several notable respects: limited risk exposure because of the investment cap,[109] the participation of the crowd in weeding out fraudulent issuers and discerning quality investments,[110] the unique function of portals, the lack of a secondary market, voting rights disproportionate to ownership, as well as potentially resolving inefficiencies in the spatial allocation of capital.[111]

As a novel securities market, crowdfunding demands a creative approach to securities regulation.[112] The Commission seemingly appreciated the delicate nature of the market;[113] yet, despite employing more investment professionals than any other executive agency or Congress, the proposed rules contain only insignificant deviations from the text of the JOBS Act.[114]

### *B. Burdensome Disclosure*

The proposed disclosure requirements will likely be so burdensome that they frustrate the JOBS Act's mission to increase

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107. *See* Gubler, *supra* note 10.

108. *See* Bradford, *supra* note 20, at 196; *see also* Heminway & Hoffman, *supra* note 6, at 933 n.275 ("Census data report that 69% of new employer establishments born to new firms in 2000 survived at least 2 years, and 51% survived 5 or more years."); *FAQ*, NAT'L VENTURE CAP. ASS'N, http://www.nvca.org/index.php?Itemid=147 (last visited Jan. 11, 2014) (stating that 40 percent of venture capital investments fail, 40 percent return moderate amounts of capital, and only 20 percent or less produce high returns).

109. *See* Schwartz, *supra* note 9, at 50.

110. *See* Bradford, *supra* note 20, at 219.

111. *See* Agrawal et al., *supra* note 22, at 35 (predicting that the online setting where crowdfunding is conducted will reduce the importance of factors that influence geography bias present in traditional funding).

112. *See* Gubler, *supra* note 10.

113. Crowdfunding, 78 Fed. Reg. 66,428, 66,430 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249) ("We understand that Title III was designed to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in relatively low dollar amounts. . . . Rules that are unduly burdensome could discourage participation in crowdfunding. Rules that are too permissive, however, may increase the risks for individual investors, thereby undermining the facilitation of capital raising for startups and small businesses.").

114. *See* Davidoff, *supra* note 12.

access to capital and create more employment.[115] The goal of securities regulation is to balance the benefits of capital formation against the cost of allowing the offerings, including potential investor losses.[116] This theory operates under the assumption that investors are adequately protected when all relevant aspects of the securities are fully and fairly disclosed.[117] Disclosure is not focused on the merits of the investment, but on arming potential investors with the information necessary to make a fully informed investment decision.[118] Congress carved out a crowdfunding exemption from the Securities Act requirements in order to alleviate the burden of compiling expensive disclosure documents for start-ups that are typically devoid of funding.[119] Thus, a practical crowdfunding exemption should entail meaningful disclosure sufficient to enable investors to evaluate the merits of the securities without unduly burdening issuers.[120]

The proposed disclosure requirements are overly burdensome because the expense of compliance is likely to render small offerings infeasible.[121] Though the Commission relaxed traditional reporting-company disclosure, compliance with the mandated disclosure still imposes significant up-front expenses to prepare financial statements simply to qualify for an offering (especially considering that the quintessential crowdfunded company will have no capital until it closes the offering).[122] Issuers might fear incurring these costs to make it to market, only to discover that the crowd does not support their products; this possibility alone is likely to serve as a powerful deterrent from using crowdfunding as opposed to other exemptions.[123]

115. *See* JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) ("An Act To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."); *see also* Shane M. Fleenor, *Comment No. 35 to Proposed Rule on the JOBS Act Title III*, SEC.GOV (Apr. 27, 2012), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-35.htm.

116. *See* Bradford, *supra* note 20, at 197–98.

117. *See* Hazen, *supra* note 44, at 1741.

118. Justice Brandeis said it best: "Sunlight is said to be the best of disinfectants . . . ." Louis Brandeis, *What Publicity Can Do*, HARPER'S WEEKLY, Dec. 20, 1913, *available at* http://www.law.louisville.edu/library/collections/brandeis/node/196.

119. *See* Heminway & Hoffman, *supra* note 6, at 909 (stating that the costs of disclosure requirements associated with the filing of an Initial Public Offering can exceed $100,000).

120. *See* Hazen, *supra* note 44, at 1767.

121. *See* Schwartz, *supra* note 9, at 46.

122. *See id.* at 49; *see also* Marielle Segarra, *The JOBS Act: Crowdfunding and Emerging Businesses*, CFO (Oct. 22, 2013), http://ww2.cfo.com/growth-companies/2013/10/the-jobs-act-crowdfunding-and-emerging-businesses (estimating the cost of an adequate disclosure statement to be between $50,000-100,000) (quoting Brian Korn, Securities Attorney, Pepper Hamilton).

123. *See infra* Part II.E.

Specifically, the audit requirement for companies seeking to raise over $500,000 is onerous.[124] The mere cost of an audit is likely to cannibalize 10 percent of the total offering amount, notwithstanding the intermediary's commission fee and the cost of compliance with additional Form C disclosure requirements.[125] This provides an incentive for entrepreneurs to minimize up-front costs by setting lower target amounts, thereby leaving the company undercapitalized and more prone to failure.[126] Offerings that involve a significant intellectual property (IP) component face an additional deterrent, as they must disclose sensitive information about their innovation and, in doing so, risk another founder imitating their concept.[127] If these fears keep otherwise-viable projects from reaching crowdfunding portals, depriving investors of the returns on these promising projects as a result, then the Commission will have effectively created a stillborn securities market.[128]

Further, it is highly probable that the disclosures will have little effect on whether a project is ultimately funded, as the average crowdfunding investor is unlikely to perform extensive due diligence before making an investment decision.[129] The investment limitation exacerbates this concern by providing a disincentive for funders to invest time and money researching companies relative to traditional forms of investment involving larger capital outlays.[130] Additionally, crowdfunded offerings are likely too small to warrant professional

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124. *See* Heminway & Hoffman, *supra* note 6, at 909 n.145; *see also Should You Pay For Audited Financial Statements?*, BUSINESS OWNER, http://www.thebusinessowner.com/business-guidance/accounting/2009/07/should-you-pay-for-audited-financial-statements (last visited Nov. 23, 2013) (estimating audit costs for a small to mid-size company range from $7,000–50,000).

125. *See* Crowdfunding, 78 Fed. Reg. 66,427, 66,565 (proposed Jan. 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 240, and 249).

126. *See* Fleenor, *supra* note 115.

127. This risk is highest during the capital raising period, before the product is actually launched. Other sources of capital allow a founder to keep their innovation secret. *See* Agrawal et al., *supra* note 11, at 16–18.

128. *See* Richard Waters, *Start-ups Seek the 'Wisdom of Crowds,'* FINANCIAL TIMES (Apr. 3, 2012, 7:41 PM), http://www.ft.com/intl/cms/s/0/c1f1695c-7da8-11e1-9adc-00144feab49a.html ("If the top 5 percent [of start-ups] avoid crowdfunding, the crowd won't make any money." (quoting Naval Ravikant, Co-Founder, AngelList)); *see also* Fleenor, *supra* note 115 ("However, if the SEC over-burdens issuers and/or investors, there is a very real possibility that demand for crowdfunding will be choked off, and our small businesses will not obtain the capital they need to grow. The capital markets are failing our small businesses, to the detriment of our under-employed citizenry. Congress recognized this failure, and passed the JOBS Act in an attempt to rectify the situation.").

129. Data from consumer contracting research suggests that online disclosures are largely ignored, similar to 'Terms & Conditions.' *See* Schwartz, *supra* note 9, at 46.

130. *See* Agrawal et al., *supra* note 11, at 20; *see also* Ahlers et al., *supra* note 7, at 1 ("Small investors, who are often the primary support of start-ups, do not usually have the capability to extensively research and assess potential investments.").

analysis, placing the full burden of conducting due diligence on investors.[131] Empowering the crowd may alleviate this problem.[132]

The annual investment limitation, as opposed to extensive disclosure, will function as the fundamental protection for crowdfunding investors because of the speculative information that start-ups disclose combined with the likelihood that funders might disregard these disclosures.[133] Crowdfunding companies are inherently risky and the online offerings raise significant fraud concerns.[134] Additionally, the crowd is composed of unsophisticated investors with relatively shallow pockets.[135] The proposed rules account for these factors by ensuring investors cannot risk more money than they can afford to lose.[136] This puts crowdfunding in stark contrast to other forms of investment—such as gambling, buying lottery tickets, or playing the stock market—where an individual can legally risk their entire life savings.[137]

Portals bear responsibility for policing the annual investment limitation, though they can fulfill this obligation by relying on investors' representations.[138] This enforcement mechanism enables individuals to invest in excess of the annual limit by misrepresenting (either intentionally or carelessly) the extent of their total investments across multiple platforms.[139] While this would constitute fraud by the funder and lead some to believe these individuals are not deserving of protection, the SEC should foreclose the possibility due to the vulnerability and modest means of the target audience.[140]

The most burdensome aspect of the proposed disclosure requirements may ultimately prove to be issuer liability.[141] By filing

131. *See* Schwartz, supra note 9, at 46.
132. *See infra* Part II.C.
133. *See* Schwartz, *supra* note 9, at 46.
134. *See id.* at 45.
135. *See id.* at 50–51.
136. *See id.* ("This is a structural protection against losing one's life savings to a crooked crowdfunder."); *cf.* Hazen, *supra* note 44, at 1766 ("It also is likely to attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money.").
137. *See* Schwartz, *supra* note 9, at 51 ("This is a structural protection against losing one's life savings to a crooked crowdfunder.").
138. *Id.* at 59–60.
139. *See id.* at 60.
140. *See id.*; *see also Faith Bautista, Comment No. 38 of Asian American Community on SEC Proposal for Crowdfunding: Recipe for Disaster*, SEC.GOV (Oct. 31, 2013), http://www.sec.gov/comments/s7-09-13/s70913-38.pdf ("This ill-conceived Ponzi plan does not even require that a startup seeking funds verify compliance with what are admittedly loose investment limits. That is, a family that previously never earned more than $40,000 a year (with a breadwinner that has just lost her job and is now dependent [on] food stamps) could easily pretend that she has $250,000 in income and invest $25,000 a year. She could therefore invest her entire 401(k) retirement in a startup where the chances of success are less than one in a hundred.").
141. *See* Segarra, *supra* note 122.

annual reports, issuers assume public-offering-style liability for misrepresentations and omissions of material information.[142] Issuers will surely make disclosure mistakes in a market that forces inexperienced entrepreneurs to comply with sophisticated disclosure requirements that implicate a detailed understanding of corporate finance and law.[143] Wisely, the proposed rules include a substantial compliance provision that will protect unsophisticated founders from liability for insignificant and good faith mistakes.[144] In addition, civil actions will not be an appropriate remedy because of the modest damages to each funder and the likely insolvency of founders (successful investments rarely lead to litigation).[145] Thus, some form of cost-effective alternative dispute resolution must emerge to determine the extent of issuer liability.[146]

### *C. Wisdom of the Crowd*

Numerous commentators have emphasized crowdfunding's potential to induce fraudulent activity.[147] Studies conducted on rewards-based crowdfunding suggest that prior funding decisions of project backers exert considerable influence on the subsequent funding decisions of other backers.[148] This irrational herding behavior attracts fraudulent issuers, as founders might initially invest a large sum to lend the project an appearance of credibility then withdraw their capital as they approach their goal.[149] The classic fraudulent offering involves an issuer who accepts investments for a fictitious project and disappears after the offering closes.[150] Further, over 90

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142. *See id.* (quoting Brian Korn, Securities Attorney, Pepper Hamilton).

143. *See* Bradford, *supra* note 20, at 217; *see also* Judy Magness, *Defeating Crowdfunding Fraud*, SUIT (Oct. 28, 2013), http://www.thesuitmagazine.com/business/finance/22127-defeating-crowdfunding-fraud.html ("The sort of fraud we see in this area is often totally inadvertent, where somebody doesn't realize that what they are saying cannot be said without explaining the background behind it . . . . Entrepreneurs need to understand exactly what their obligations are." (quoting Sara Hanks, founder of CrowdCheck & former partner at Clifford Chance)).

144. *See* Crowdfunding, 78 Fed. Reg. 66,427, 66,550 (to be codified at 17 CFR §227.502).

145. *See* Hazen, *supra* note 44, at 1759.

146. *See* Mark Norych, *Comment No. 247 to Proposed Rules on the JOBS Act Title III*, SEC.GOV (July 19, 2013), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-247.pdf (suggesting that the most appropriate forum for crowdfunding disputes is Internet arbitration, considering the costs of travel relative to the meager potential award).

147. *See supra* note 98 and accompanying text.

148. *See* Venkat Kuppuswamy & Barry L. Bayus, *Crowdfunding Creative Ideas: The Dynamics of Project Backers in Kickstarter* 2 (UNC Kenan-Flagler Research Paper No. 2013-15, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2234765.

149. *Id.*; Agrawal et al., *supra* note 22, at 30.

150. *See, e.g.*, Julianne Pepitone, *Kickstarter Pulls Plug on Scam Minutes Before $120,000 Heist*, CNN MONEY (June 17, 2013, 2:22 PM), http://money.cnn.com/2013/06/17/technology/kickstarter-scam-kobe-jerky/index.html (documenting a fraudulent

percent of creators propose only one crowdfunded project, so even bona fide issuers are typically unproven commodities.[151]

But outright fraud constitutes less than 5 percent of crowdfunded projects,[152] so the more realistic concern for investors is that issuers might fail to exert a good faith effort to make their project a success.[153] Once the money is in the issuer's hands, funders exhibit very little control over the use of those proceeds because they have no voting power and cannot sell their shares in a secondary market.[154] Their position is analogous to a shareholder in a closely held corporation, where there is high potential for oppression.[155] The ongoing reporting requirements provide some manner of oversight, but funders would have to result to litigation if they are unsatisfied with their investment, which is not an economically efficient solution.[156]

Research on nonequity crowdfunding shows that signals from issuers related to quality and preparedness exert considerable influence over investment decisions.[157] These signals include posting a video on the portal page, providing rapid and continuous updates on funding goals, minimizing typos, social network size, patent ownership, founders with success in other ventures, and the founders' education level.[158] Outside of the crowdfunding context, eBay and Amazon's rating systems demonstrate the crowds' power to influence Internet investment decisions.[159]

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campaign to produce Kobe Red beef jerky, which nearly succeeded in scamming 3,300 investors out of $120,000 before Kickstarter pulled the project off its website).

151. *See* Kuppuswamy & Bayus, *supra* note 148 at 9.

152. *See* Mollick, *supra* note 21, at 11; *see also* Waters, *supra* note 128 (noting that, according to IndieGoGo CEO Slava Rubin, fraud accounts for less than 1 percent of money raised on Indiegogo).

153. See Davidoff, *supra* note 12 (chronicling *The Doom That Came to Atlantis*, a board game that raised $122,000 preselling versions of the game, which the founder spent to move to Portland, Oregon before declaring the project unsuccessful).

154. *See* Schwartz, *supra* note 9, at 54; *see* Davidoff, *supra* note 12.

155. *See* Schwartz, *supra* note 9, at 54.

156. *See supra* note 136.

157. This phenomenon—high-quality projects attract backers who may promote the project to other potential backers, or external media, thus increasing the draw of the project—is called the Matthew Effect. *See* Mollick, *supra* note 21, at 6, 8 ("In a setting where amateurs are making decisions about which projects to finance, and taking into account the social networks that would tend to be sources of both funding and endorsements, the effect of these signals of quality and preparedness is unexpectedly large.").

158. *See id.* at 8; Waters, *supra* note 128; Pepitone, *supra* note 150.

159. *See* Schwartz, *supra* note 9, at 58; Waters, *supra* note 128.

### *D. Unique Characteristics of Portals*

As a matter of cost shifting, portals can shoulder the burden of policing crowdfunding.[160] Portals employ a revenue model that charges a transaction fee of four to five percent for all successfully funded projects, which could generate up to $200–250 million in annual revenues for portals.[161] In addition, if trends in other crowdfunding markets translate to the equity-based market, a single platform will ultimately establish market dominance.[162] The value of the platform to creators increases with the number of funders, and vice versa, thus each platform has a strong market incentive to attract high-quality projects, reduce fraud, and facilitate the efficient allocation of capital to the best ideas.[163] More importantly, as most project founders only participate in one crowdfunded project, placing too much of the regulatory burden on issuers might deter them from bringing their project to the market.[164] Therefore, portals are in the best position to incur up-front regulatory costs, amass pertinent information from both investors and issuers, and then spread those costs and benefits among all market participants.[165]

With that said, prohibiting portals from screening issuers does a great disservice to investors.[166] Intermediaries are tasked with implementing controls to detect fraudulent offerings.[167] This includes

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160. One commenter noted:

> [A]s the [portals] whose business expressly involves interjecting ourselves into the middle of the financial system, of registering with the SEC and joining an SRO, of dealing with crowdfunding on a daily basis, it is only natural that we should shoulder the regulatory burden for this new crowdfunding regime. Were [sic] the ones who should be digging into the code and the rules, working with our lawyers to develop a platform that is fully compliant [sic] were [sic] the ones who should be responsible for ensuring that the system is sustainable, and that investors are protected.

Fleenor, *supra* note 115.

161. *See* Agrawal et al., *supra* note 22, at 15 (computing 4–5 percent (the typical portal commission fee), times $5 billion (one projected market estimate) to equal $200–250 million).

162. *See id.*

163. *See id.* at 16.

164. The same commenter explained with concern:

> If the SEC heavily burdens the intermediaries, it may force some participants out of the market, but there will be players willing to incur the extra burdens – we believe the supply of intermediary services will be adequate in any event. However, if the SEC over-burdens issuers and/or investors, there is a very real possibility that demand for crowdfunding will be choked off, and our small businesses will not obtain the capital they need to grow. The capital markets are failing our small businesses, to the detriment of our under-employed citizenry. Congress recognized this failure, and passed the JOBS Act in an attempt to rectify the situation.

Fleenor, *supra* note 115.

165. *See id.*

166. *See* Agrawal et al., *supra* note 22, at 19.

167. Intermediaries are obliged to "take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule . . . ." *See* Crowdfunding,

performing basic background checks and securities-enforcement regulatory-history checks on all relevant members of the issuer's management team.[168] The rules currently prohibit portals from offering "investment advice or recommendations."[169] This language is ambiguous and, if broadly construed, might preclude portals from screening projects with a high potential for fraud or failure.[170] While there may be wisdom in prohibiting portals from offering investment advice, sites such as SeedInvest are extremely successful in preventing fraudulent projects from reaching their investors but do so by filtering out 98 percent of proposed projects.[171] This evidence strengthens the argument that equity-based platforms stand to benefit from at least a basic project screening process.[172] Decreased incidences of fraud will increase trust in the crowdfunding market, leading to the optimal allocation of capital.[173] Hence, it is preferable to empower intermediaries to pre-screen projects, even if this increases the average cost of an offering.[174]

### *E. Crowdfunding: The Inferior Alternative*

Ultimately, crowdfunding's problem is this—who will use it? It is plausible that the crown jewel of the JOBS Act will ultimately be Title II,[175] which lifted the ban on general solicitation and advertising of private placement offerings utilizing the Regulation D exemption.[176] Perhaps it will be Title I, which equipped emerging growth companies with an arsenal of tools (such as 'testing the waters'[177]) for conducting

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78 Fed. Reg. 66,428, 66,461 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

168. *See id.*

169. *See* Bradford, *supra* note 20, at 220.

170. *See id.*

171. *See* Segarra, *supra* note 122.

172. *See* Segarra, supra note 122; Agrawal et al., *supra* note 22, at 22.

173. *See* Heminway & Hoffman, *supra* note 6, at 936.

174. *See* Agrawal et al., *supra* note 22, at 19.

175. Known as 'Accredited Investor Crowdfunding.' *Accredited Investor Crowdfunding Platforms: A Brief History*, CROWDSOURCING.ORG (Mar. 25, 2014, 5:36PM), http://www.crowdsourcing.org/editorial/accredited-investor-crowdfunding-platforms-a-brief-history/31099.

176. Regulation D is a separate exemption from SEC registration requirements. *Id.* While the JOBS Act permits general solicitation & advertising of Reg. D offers, only qualifying accredited investors may actually purchase the securities. *See* JOBS Act § 201 et. seq., 15 U.S.C. § 77d (2012); *see* Bradford, *supra* note 20, at 222.

177. Testing-the-waters meetings enable issuers to communicate with prospective investors prior to an offering in order to gauge investor interest and disseminate pertinent information to interested investors. *See* Tracy Cooley, *JOBS Act Deconstructed: Testing-the-Waters*, BIOTECHNOW (Oct. 14, 2013), http://www.biotech-now.org/business-and-investments/2013/10/jobs-act-deconstructed-testing-the-waters; LATHAM & WATKINS, LLP, THE JOBS ACT AFTER ONE YEAR: A REVIEW OF THE NEW IPO PLAYBOOK 6–7 (Apr. 5, 2013), *available at* http://www.sec.gov/info/smallbus/acsec/acsec-091713-lathamreport-slides.pdf.

successful IPOs.[178] Offerings relying on the crowdfunding exemption, by contrast, are not permitted to advertise beyond providing a link that directs investors to the platform.[179]

Importantly, start-ups and small businesses conducting offerings in reliance on Regulation D circumvent costly disclosure requirements by allowing issuers to simply open their books to potential investors.[180] This is especially attractive to IP-intensive projects, as they do not have to expose potentially sensitive information to the general public or competitors.[181] These companies would not have to file with the SEC, nor place their offering through a registered intermediary.[182]

The most attractive aspect of Regulation D, however, is that it allows offerors to raise an unlimited amount of money without restricting the amount each individual investor can purchase.[183] This is a potential deal breaker for founders whom are choosing among financing alternatives, as crowdfunding's high compliance expenses compared to the low maximum investment total provide perhaps the worst "bang for your buck" in corporate finance.[184]

Further, founders might use nonequity forms of crowdfunding to raise seed capital while signaling the quality of their project to bigger investors and receiving constructive feedback from the crowd. Thus, they avoid equity-crowdfunding altogether and are more attractive for follow-on financing from established investors whom provide status, extensive networks, and industry expertise.[185] It is also possible that some companies soliciting purely intrastate investment will take advantage of Direct Public Offerings, an increasingly popular trend in the start-up community.[186] With several

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178. The report also lists: (1) Confidential SEC Review; (2) Scaled Financial Disclosure; (3) Internal Controls Audit; (4) Executive Compensation Disclosure; (5) Extended Phase-In for New GAAP; and (6) PCAOB Rules as mechanisms Title I permits an EGC to utilize. *JOBS Act After One Year*, *supra* note 177, at 5.

179. *See* Jacobs, *supra* note 101.

180. *See id.*

181. *See* Agrawal et al., *supra* note 22, at 16.

182. *See* Segarra, *supra* note 122.

183. *See* Bradford, *supra* note 20, at 222.

184. *See* Jacobs, *supra* note 101.

185. An additional benefit of using nonequity crowdfunding for the initial financing round is avoiding dilution, thereby making the company more attractive in follow-on financing rounds. *See* Agrawal et al., *supra* note 22, at 7.

186. *See* Jenny Kassa, *The JOBS Act Leaves Crowdfunding Investors Unprotected—the SEC is Working with a Flawed Law*, VENTURE BEAT (Oct. 31, 2013, 6:19 AM), http://venturebeat.com/2013/10/31/the-jobs-act-leaves-crowdfunding-investors-unprotected-the-sec-is-working-with-a-flawed-law. The appeal of these offerings is clear:

> In a typical initial public offering, a Wall Street underwriter markets shares to wealthy clients and institutional investors, taking a cut of the proceeds. In a direct offering, shares are marketed directly by the issuing company, typically to customers, supporters and, these days, social media followers. The companies may advertise the

more attractive financing options for quality investments, crowdfunding may become a market for projects that could not arrange financing elsewhere unless the Commission makes significant alterations to the proposed rules.[187]

## III. A COMPROMISE: LOWERING BARRIERS TO ENTRY WITHOUT SACRIFICING INVESTOR PROTECTION

When Congress inserted a blunderbuss clause in the JOBS Act, they empowered the Commission to supplement the statutory text with "such other requirements as the Commission may, by rule, prescribe for the protection of investors and in the public interest."[188] This could, and should, be interpreted as permission to experiment with the crowdfunding market.[189] Crowdfunding raises a host of novel legal questions to which there are no concrete solutions. Thus, the legislation permits, and the market demands, a trail-and-error approach to regulation.[190]

It is important to remember that the Securities Act is not an insurance policy against investor losses.[191] Crowdfunding's pitfalls are well documented: increased fraud potential from relaxed disclosure requirements coupled with the Internet's tendency to encourage irrational decision making.[192] The actions of portals in

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> offering freely and accept funds from an unlimited number of unaccredited, or nonwealthy, investors. And the companies are not subject to the quarterly reporting requirements and comprehensive registration process that come with an initial offering.
>
> . . . A direct offering might cost around $25,000 in legal fees, while a formal initial public offering can cost $1 million or more.

Amy Cortese, *Seeking Capital, Some Companies Turn to 'Do-It-Yourself I.P.O.'s,'* N.Y. TIMES, July 31, 2013, http://www.nytimes.com/2013/08/01/business/smallbusiness/seeking-capital-some-companies-turn-to-do-it-yourself-ipos.html.

187. *See* Agrawal et al., *supra* note 22, at 36.

188. *E.g.* Schwartz, *supra* note 9, at 61.

189. For example, a number of commentators insist the SEC has the power to raise the maximum offering amount and doing so would create a more viable market. *See, e.g.*, Albert Hartman, *Comment No. 79 to Proposed Rules on the JOBS Act Title III*, SEC.GOV (June 4, 2012), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-79.htm; Robert B. Nami, *Comment No. 81 to Proposed Rules on the JOBS Act Title III*, SEC.GOV (June 5, 2012), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-81.htm (stating a minimum of $5–10 million is necessary to start any business other than software); Richard W. Marks, *Comment No. 87 to Proposed Rules on the JOBS Act Title III*, SEC.GOV (June 14, 2012), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-87.htm (advocating raising the maximum offering amount to $5 million); Peter Ojo, *Comment No. 76 to Proposed Rules on the JOBS Act Title III*, SEC.GOV (May 31, 2012), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-76.htm (arguing crowdfunding's maximum offering amount should be similar to Regulation D); Davidoff, *supra* note 12.

190. *See* Gubler, *supra* note 10.

191. *See* Heminway & Hoffman, *supra* note 6, at 934.

192. *See id.* at 934, 937.

nonequity crowdfunding, however, suggest that the equity-crowdfunding market will likely remedy many of its own problems if portals are free to innovate.[193] So long as the market produces a net value-add (i.e., facilitates greater incremental business creation than incremental fraud increase) crowdfunding will be a success.[194] Crowdfunding will not add value if burdensome regulation prevents many promising projects from reaching the market.[195] Accordingly, the Commission should treat the market with a light regulatory touch.[196]

The Commission should take advantage of Congress' broad delegation to regulate the crowdfunding market by making significant deviations from their proposed rules when promulgating final regulations. Crowdfunding is intended to attract a different type of company than traditional securities markets and, consequently, different investors.[197] Considering the participants, the market requires a unique regulatory structure.[198] Yet, the Commission resorted to old tactics.[199] In the final rules, the Commission should relax disclosure requirements, enable portals to prescreen projects, and eliminate restrictions on the crowd's ability to communicate.

### *A. Simplifying Disclosure Requirements*

An appropriate crowdfunding exemption should drastically reduce disclosure requirements given the lack of reliable information and the low maximum offering amount relative to other financing alternatives.[200] Regulation should not discourage companies from listing their projects on portals, because a diversified mix of projects increases the probability of profitable investment.[201] Burdensome disclosure requirements directly frustrate this goal.[202] Simple

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193. *See* Agrawal et al., *supra* note 22, at 31 (noting how nonequity platforms almost uniformly converged on a provision-point mechanism—not disbursing funds unless a project reaches its funding threshold—absent any regulatory prodding).

194. *See* Heminway & Hoffman, *supra* note 6, at 940–45.

195. *See supra* note 128 and accompanying text.

196. *See* Schwartz, *supra* note 9.

197. *See The JOBS Act: Economic Boon or Peril?*, *supra* note 1 ("The goal of the JOBS Act is to have more companies fail faster . . . . This isn't a side effect, this is really the main effect of improving the startup economy: getting more people to try more ideas, which inherently means more failure. But it also means more experience, it means more surprises, it means lower cost. In a way, the criminogenic argument seems to me to get halfway towards what the JOBS Act is actually targeted for in that it recognizes this lowering of the threshold to participation—but [the JOBS Act] also lowers the cost of participation." (quoting Clay Shirky)).

198. *See* Davidoff, *supra* note 12.

199. *Id.*

200. *See supra* Part II.B.

201. *See* Agrawal et al., *supra* note 22, at 16.

202. *See supra* Part II.B.

disclosure requirements would allow issuers to highlight the important aspects of the investment, such as the price and percentage of ownership.[203] Because of the unsophisticated nature of crowdfunding investors and the infancy of crowdfunded businesses, issuers should be required to explain who they are, what they seek to produce, their basic business plan, current financial condition (focusing on definite liabilities), the intended purpose of the funds, and what the investor receives from their investment (i.e. ownership stake, voting rights, etc. . .).[204]

The relatively small maximum offering amount does not justify extensive disclosure.[205] The final version of Form C should be significantly less complex than the current iteration, providing issuer's with the simple disclosure process they desire.[206] Ideally, issuers could complete Form C by selecting from a database of stock responses, rather than paying professionals to compile their disclosures. Additionally, if the final regulations include a "testing the waters" provision with crowdfunding-appropriate modifications,[207] then issuers could make informed decisions about where to set their target offering amount or whether they should avoid an unsuccessful offering altogether.[208]

The tiered-disclosure requirement should mimic Regulation D, where entrepreneurs have the option of providing only an audited balance sheet if obtaining fully audited financial statements would require "unreasonable effort or expense."[209] It is fair to say that spending over 10 percent of the total amount raised on audited statements constitutes an unreasonable expense.[210] Providing a

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203. *See* Jonathan Schatz, *Comment No. 53 to Proposed Regulations on Crowdfunding*, SEC.GOV (Nov. 13, 2013), http://www.sec.gov/comments/s7-09-13/s70913-53.htm.

204. *See* Robert C. Guinto, Jr., *Comment No. 13 to Proposed Regulations on Crowdfunding*, SEC.GOV (Oct. 24, 2013), http://www.sec.gov/comments/s7-09-13/s70913-13.htm.

205. Regulation A offerings were capped at $5 million before recent changes by JOBS Act Title IV allowed Regulation A offerings to issue as much as $50 million of equity, subject to more stringent reporting requirements. *See* Dave Lynn, *SEC Proposes Long-Awaited Regulation A+ Rules*, CORPORATE COUNSEL (Dec. 19, 2013), http://www.thecorporatecounsel.net/Blog/2013/12/sec-proposes-long-awaited-regulation-a-rules.html.

206. Examples of a scaled-down disclosure document include Form 1-A (before JOBS Act modifications) or NASAA's 1989 Form U-7. *See* Guinto, *supra* note 204. Ideally, Form C will be less detailed than either of these examples, in proportion to crowdfunding's relatively low maximum offering amount. *Id.*

207. *See supra* note 177 and accompanying text. For example, allowing issuers to conduct a survey of potential investors regarding their level of interest in the project and potential investment commitment; or, allowing investors to make a commitment contingent on more detailed disclosure.

208. *See* Fleenor, *supra* note 115 ("If issuers could, at a low cost, obtain some confidence that their raise will be successful, they may be more inclined to spend their literal bottom dollar on the legal and accounting fees necessary to undertake a crowdfunding offering.").

209. Regulation D § 502(b)(2)(B) (codified at 17 C.F.R. § 230.502(b)(2)(B)).

210. *See supra* note 122 and accompanying text.

balance sheet, though, will warn investors of the company's existing financial obligations (if any), which pose a major impediment to profitable investment.

Minimizing disclosure requirements increases the risks for investors.[211] Therefore, to maintain sufficient investor safeguards, the Commission should require portals to actively confirm that investors do not exceed their annual investment limitation. The annual investment limitation functions as the fundamental investor protection in crowdfunding.[212] The proposed rules allow investors to self-certify their level of wealth and investment activity,[213] but the unique dynamics of crowdfunding demand a stricter oversight process. As it currently stands, the self-certification procedure is too easy for investors to circumvent when they discover a "can't miss" project, but an additional investment would exceed their annual limit.[214] A competently managed portal can hire third-party providers to verify individuals' investment sums, and then distribute these costs among market participants.[215]

### *B. Portal Pre-Screening Power*

The proposed rules prohibit portals from offering "investment recommendations or advice."[216] The SEC should clarify what constitutes a recommendation or advice to exclude internal pre-screening decisions. As for-profit concerns, portals have a market incentive to permit as many quality projects as possible to solicit investments on their site. Rewards-based crowdfunding suggests the market will come to be dominated by a single platform,[217] and portals operate on a model where they receive the majority of their profit from successfully funded ventures.[218] It is in their interest to ensure the

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211. *See* Hazen, *supra* note 44, at 1763.

212. *See* Schwartz, *supra* note 9, at 60.

213. Self-certification is customary for most securities offerings. *See* Bradford, *supra* note 20.

214. *See* Schwartz, *supra* note 9, at 60.

215. Third party service providers will race to fill this space. For example, an Ohio startup, Crowdentials Inc., recently launched an investor accreditation verification product in response to JOBS Act Title II's allowing general solicitation. *See* Lora Kolodny, *Crowdentials Wants to Make Investor Verification 'TurboTax Easy' Online*, WALL ST. J. BLOG (Jan. 13, 2014, 2:21 PM), http://blogs.wsj.com/venturecapital/2014/01/13/crowdentials-wants-to-make-investor-verification-turbotax-easy-online.

216. Crowdfunding, 78 Fed. Reg. 66,427, 66435 (proposed Jan. 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 240, and 249).

217. *See* Agrawal et al., *supra* note 22, at 3.

218. *Id.* at 16.

platform offers attractive projects to funders in order to build a loyal base of investors, which in turn attracts more quality projects.[219]

Kickstarter recently adopted a pre-screening process to maximize transaction volume.[220] After undergoing a trial-and-error process, its management believes the benefit of reducing risk for funders outweigh the monitoring costs.[221] Likewise, the SEC should grant equity-based crowdfunding portals similar discretion to pre-screen offerings for fraud.[222] To achieve this end, portals can hire investment professionals to evaluate proposed projects, thereby submitting only bona fide projects to investors.[223] In this way, investors will gain trust in the market and rely more on the wisdom of the crowd to discern promising investments.[224]

In addition to fraudulent offerings, portals should be permitted to filter out impractical projects.[225] For example, Kickstarter changed their guidelines to impose more stringent requirements for Hardware and Product Design projects after discovering they had a higher propensity to fail when they consisted solely of renderings or product simulations as opposed to an actual prototype.[226] Additionally, some projects require far in excess of $1 million to complete.[227] Ultimately,

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219. *Id.*

220. *See* Agrawal et al., *supra* note 22, at 25 ("These efforts are focused on fraud and acceptable uses of Kickstarter, not a creator's ability to complete a project and fulfill. On Kickstarter, backers ultimately decide the validity and worthiness of a project by whether they decide to fund it.").

221. *Id.* ("For example, Kickstarter recently allocated additional resources to detect fraud, implying that its management believes the benefits of doing so (lower risk for funders) outweigh the costs (increased monitoring costs for the platform and higher disclosure burden on creators.").

222. *Compare* SEED INVEST, https://www.seedinvest.com/about (last visited Mar. 20, 2014) ("We are not a listing service. We only feature highly vetted investment opportunities that adhere to strict requirements."), *with* Beth Potter, *Funding Launchpad Changes Name, Focus*, BOULDER COUNTY BUS. REP. (Aug. 22, 2013, 2:10 PM), http://www.bcbr.com/article/20130822/NEWS/130829972 ("Investments listed on the Grofolio.com website all will be vetted by an investment bank . . . .").

223. *See* Segarra, *supra* note 122.

224. *See* Agrawal et al., *supra* note 22, at 22 ("Traditional markets for the financing of early-stage creative projects or ventures rely heavily on due diligence predicated on face-to-face interactions and personal relationships. In the crowdfunding setting, creators disclose as much information as they wish and then rely on an ethos of 'trust me.' Market design may influence the efficacy of a 'trust me' environment by facilitating markets for reputation. In other words, in crowdfunding markets, as in many other online markets, reputation and trust are particularly important.").

225. *See* Perry Chen, Yancey Strickler, & Charles Adler, *FAQ: Guidelines for Hardware and Product Design Projects*, KICKSTARTER BLOG (Sept. 24, 2012), http://www.kickstarter.com/blog/faq-guidelines-for-hardware-and-product-design-pro.

226. *See* Agrawal et al., *supra* note 22, at 19, 25–26; Perry Chen, Yancey Strickler, & Charles Adler, *Kickstarter Is Not a Store*, KICKSTARTER BLOG (Sept. 20, 2012), http://www.kickstarter.com/blog/kickstarter-is-not-a-store.

227. *See e.g.*, *Oculus Rift: Step Into the Game,* KICKSTARTER.COM, https://www.kickstarter.com/projects/1523379957/oculus-rift-step-into-the-game (last visited Apr.

the viability of a project should hinge on whether crowdfunders invest, but portals can add value and build trust by removing projects that clearly have no chance of success, yet might appear legitimate enough to attract investment.[228]

### C. Collective Crowd Consensus

Crowdfunding can distinguish itself from traditional sources of capital by leveraging the "wisdom of the crowd"[229] and its critical role in protecting investors from fraudulent crowdfunded projects.[230] By providing open communication channels, portals allow the community of investors to share their knowledge, ranging from information about the founders to industry-wide risks, collectively arriving at an ostensibly rational decision.[231] If communication channels are sufficiently open to allow for the free flow of information among the crowd, the heavy lifting in making investment decisions—filtering out the best projects and limiting fraud—will be spread among the crowd, rather than subject to the diligence of each individual.[232]

Though the locus of crowdfunding regulation is on the general lack of sophistication of crowdfunding investors, the fact is that 'sophisticated' investors don't necessarily enjoy superior returns on their investments.[233] Since the beginning of 1994, the performance of major hedge funds is nearly identical to the annual returns on the S&P 500.[234] Ultimately the purpose of regulation is to ensure investors are sufficiently informed, not to ensure a successful

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11, 2014) (showing the origins of the Oculus Rift virtual reality headset, which raised over $2.4 million on Kickstarter to develop a prototype before Facebook acquired the rights for over $2 billion).

228. *See, e.g.*, Agrawal et al., *supra* note 22, at 20–21; *see also* Bryan Taylor, *How John Keely Screwed Investors and Tricked the World with His Perpetual Motion Machine*, BUS. INSIDER (Dec. 10, 2013, 1:29 PM), http://www.businessinsider.com/john-keelys-perpetual-motion-machine-2013-12 (chronicling how the purported inventor John Keely raised over $5 million for research & development of a "etheric generator" perpetual motion machine, without ever delivering a finished product, or even a prototype, to investors before his death in 1898).

229. *See* Bradford, *supra* note 20, at 219–20 ("[T]he idea that 'even if most of the people within a group are not especially well-informed or rational . . . [the group] can still reach a collectively wise decision.'").

230. *See* Mollick, *supra* note 21, at 7; *see also* Little Monster Productions, *Mythic: The Story of Gods and Men*, KICKSTARTER, http://www.kickstarter.com/projects/273246798/mythic-the-story-of-gods-and-men/comments (last visited Jan. 12, 2014) (exemplifying how an active crowd can expose a fraudulent issuer).

231. *See* Bradford, *supra* note 20, at 219–20.

232. *See* Waters, *supra* note 128.

233. *See* Walter Kurtz & Sober Look, *The 20-Year Performance of Hedge Funds and the S&P 500 Are Almost Identical*, BUS. INSIDER (Aug. 12, 2013, 8:43 AM), http://www.businessinsider.com/hedge-funds-and-sp-500-nearly-identical-2013-8.

234. *See id.* (asserting that both the CS Hedge Fund Index and S&P 500 have returned 8.6 percent annually over the last twenty years).

investment.[235] Extensive disclosure is especially unnecessary in crowdfunding given that it is almost entirely speculative information at the start-up stage, thus easy to distort.[236] For crowdfunded projects, the pertinent information is accessible on the Internet and the crowd is unlikely to successfully fund a project if sufficient information to make an informed investment is not available.[237] Therefore, it is unnecessary to unduly burden issuers with extensive disclosure when the crowd can freely disseminate information.

## IV. CONCLUSION

Crowdfunding carries the potential to unleash a vast store of previously inaccessible capital into the US economy, enabling a new wave of entrepreneurs to achieve the American Dream. The only way this market will realize its full potential is if the SEC implements an innovative regulatory framework befitting a novel market. The proposed rules, as they currently stand, advance a market that has little chance to succeed. In order to create a viable market, the final regulations should relax disclosure requirements, while simultaneously empowering portals to pre-screen offerings and the crowd to disseminate pertinent information. As it is operating in uncharted territory, the Commission would do well to adopt a trial-and-error approach to regulation. If the Commission can strike the proper balance of protecting investors without imposing prohibitive costs on issuers, then investors will allocate capital to the most promising projects, achieving an optimal market.

*R. Kevin Saunders II*[*]

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235. *See* Heminway & Hoffman, *supra* note 6, at 934.
236. *See* Guinto, *supra* note 204.
237. *See* Ahlers et al., *supra* note 7, at 18.

* J.D. Candidate, Vanderbilt Law School, 2015; B.S.B.A., Accounting, Ohio State University, 2012. Thank you to the editors and staff of the VANDERBILT JOURNAL OF ENTERTAINMENT & TECHNOLOGY LAW for their help assembling my thoughts into publishable form. Many thanks to Erin, Jeff, and Veronica for insightful guidance through every step of the process. Professor Yesha Yadav and Professor Daniel Gervais deserve special thanks and recognition for their constant willingness to engage in thought-provoking discussion that inspired me to dig deeper in my research.